CONGRESS – NOT THE REGULATORS – MUST DRAW HARD LINES

By U.S. Senator Edward E. Kaufman
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Since the financial meltdown in 2008, America and Congress have remained stuck at a crossroads. Not since the Great Depression of the 1930's have we experienced a financial and economic crisis of such magnitude that it forces us, as a society and lawmaking body, to reconsider the legal and institutional underpinnings of our financial system.

The history of our nation shows that we have been at this crossroads before — at times we have made the right decision, while sadly at others, we have made the wrong one. Throughout the 19th century — and the early part of the 20th — the complacency of government and the contrivances of powerful moneyed interests prevented us from achieving fundamental reform of our financial and monetary structures.

The result was that our history was replete with all-too-frequent banking panics. Regrettably, it took well over a century before we heeded the clarion call for reform.
The shared experience of the Great Depression thrust us into the harsh reality that the status quo was bankrupt. Out of the ashes of that crisis, we built a legal and regulatory edifice that endured for decades. One of the cornerstones of that edifice was a federally guaranteed insurance fund to back up bank deposits.

Another was the Glass-Steagall Act, which established a firewall between commercial and investment banking activities. Other rules were imposed on investors to tamp down rampant speculation, like margin requirements and the uptick rule on short selling.

For the next 50 years, the United States experienced relative financial calm and economic growth, with the normal business cycle providing the usual ups and downs, of course.

The edifices built in the 1930's served us well into the 1980's, until the Savings and Loan crisis, which itself was brought on by rollback of rules that applied to thrifts.

Unfortunately, with the passage of time, and even after the shock of the S & L failures, the ideology of market fundamentalism began to sweep across our regulatory environment, erasing the clear lessons of history.

These market fundamentalists argued that our financial actors could police themselves, that their own self-interest in remaining financially viable would create sufficient incentive to do thorough due diligence — far exceeding the ability of regulators to limit excessive risk by rulemaking. Systematically, these fundamentalists worked to dismantle many of the prudential New Deal era banking reforms. Their crowning achievement: the repeal of Glass-Steagall in 1999.

Wall Street and Washington were possessed by this laissez faire ethos over the past twenty years. But it was this philosophy - and the fountainhead of decisions that sprang from it - that led us blithely, and perhaps blindly, down the path to our current crisis.

Even Alan Greenspan — the avatar of the deregulatory mindset — has now admitted that this dominant concept of self-regulation was ill-conceived. In a speech one year ago this month before the Economic Club of New York, the former Fed Chairman of 19 years conceded that the "enlightened self-interest" he had once assumed would ensure that Wall Street firms maintain a "buffer against insolvency" had failed.

The sheer complexity of today's trading instruments and the supposed risk management tools used to insure them against collapse, was, he said, and I quote, "too much for even the most sophisticated market players to handle properly and prudently."

Mr. Greenspan, perhaps more than anyone else, should have known better. But instead of playing the role of the markets' fire chief, he played that of head cheerleader. For example, Mr. Greenspan applauded the trend of financial disintermediation, proclaiming that new innovations would allow risks to be dispersed throughout the system.

Unfortunately, he failed to realize that products like credit default swaps sometimes perversely encouraged banks to become empty creditors, since banks holding those credit default instruments could end up making more money if people and companies defaulted on their debts than if they actually paid them.

Of course, this was just the tip of the iceberg. Despite having the power to write and enforce consumer protection standards, the Federal Reserve did nothing to combat deteriorating origination standards in mortgage and consumer loans.

Mr. Greenspan signed off on regulations that gave banks the ability to set their own capital standards. He allowed banking institutions to leverage excessively by gorging on short-term liabilities and, in some cases, creating off-balance-sheet entities to warehouse their risky assets.

In the wake of Wall Street excess and dereliction of duty by its regulators, financial ruin descended upon the country. Ultimately it took extraordinary actions – including a multibillion dollar taxpayer bailout — to prevent us from falling into the abyss of a second Great Depression.

We narrowly avoided that fate.

But now, when Congress should be hardest at work rebuilding the edifices that had served us so well for decades, we are not. Instead, we are being lulled into a false sense of security. Many of Wall Street's biggest financial institutions, just a few months ago saved from oblivion by U.S. taxpayers, have already recovered. In some cases, they are even making record profits.

And once again, they are back to their old tricks, in particular remaining obsessively fixated on short-term trading profits – with the help of zero percent loans from the Fed window – to drive their recovery. In fact, much of the competition was killed off in the crisis so that the once stronger banks are now stronger still — allowing them to charge customers higher transaction fees, from equities to bonds to derivatives.

Many on Wall Street are engaged in high frequency trading strategies which, as the Chicago Federal Reserve branch wrote just this week, pose a systemic risk.

Fair and transparent markets are a cornerstone of American democracy. But institutions on Wall Street are riven by obvious conflicts of interest, as banks

and non-banks continue to profit even by taking positions directly adverse to those of their clients.
And Too Big To Fail remains a critical problem.

Many on Wall Street are telling us “it is too late to unscramble the egg," that we cannot separate banking and trading entities that over the past ten years have become inextricably intertwined. But the nation is counting on Congress to do what is right. We must restore and preserve the credibility of our financial markets.

We simply cannot fail to undertake what should be a dramatic reformation of our financial regulatory system. Especially as a depression – which is how today’s economy feels for the millions of Americans who have lost their jobs, their homes, their retirement savings – continues across this country, we simply cannot squander the time for fundamental reform. We can never let financial disaster happen again.
So what must we do?

Mr. Greenspan has called for “heightened” federal regulation of banks and other financial institutions. But that is not at all sufficient. That is why I was deeply gratified last month when the Obama administration took an important step in pushing Congress in a stronger direction. The President put forward a plan that had been suggested by Mr. Greenspan’s predecessor at the Fed, Paul Volcker. It went well beyond Mr. Greenspan's call for mere “heightened” regulation.

Chairman Volcker’s plan would ban commercial banks from engaging in proprietary trading that does not benefit their clients. In other words, as Mr. Volcker has explained, banks should stick to banking, providing both credit to those who need it and an efficient global payment system, without which of course our worldwide economy cannot work.

Banks should exist to serve their customers, not as platforms on which an elite class of traders make their careers — and their mind-boggling bonuses.

Sound advice, Mr. Chairman.

Remarkably, some on Wall Street and in Washington have been arguing that proprietary trading did not cause the crisis, even though the crisis began on Wall Street with the collapse of a Bear Stearns hedge fund, even though all of the major firms involved in the crisis built up major proprietary positions in collateralized debt obligations and other securities.

As Professor Roy Smith of New York University, a former Goldman, Sachs partner, said: "Those weren't client-driven trades. They decided to take them themselves. The idea that proprietary trades were a trivial part of the losses at the banks is just not realistic." These same critics are now looking to poke holes in the Volcker proposal – to put it to death by a thousand cuts.

They state that proprietary trading can't be distinguished from normal market-making activities. They add that customer money is oftentimes invested alongside the firm's capital in proprietary ventures.

Before it is even considered in Congress, they have found facile arguments to undermine the very spirit of the proposal. These critics would leave the decision-making to the regulators. And I could not disagree more.

So while I applaud Chairman Volcker's direction, I believe we need to go even further.
We cannot pass the buck to our regulatory agencies. We have tried that before.
They punted their responsibilities to the credit rating agencies and to the banks themselves — and we were left with disastrous consequences. As a recent feature in the Economist stated, the big issue we face is "not how to make regulation cleverer, but how to protect taxpayers from a huge bill when all the precautions fail and a bank steps into the void."

Congress needs to draw hard lines that get directly at the structural problems that afflict Wall Street and our largest banks. We must draw lines that divide financial institutions which are "too big to fail." And we must draw lines that end the conflicts of interest that literally and inevitably serve to corrupt some of our most important financial institutions.

I've been around the Senate for 37 years. And I know that laws are usually not written with hard and fast lines. Laws are a product of legislative compromise, which often means they are vague and ambiguous.

And we often justify our vagueness by saying the regulators to whom we grant statutory authority are in a better position than we are to write the rules – and then to apply those regulatory rules on a case-by-case basis.

But this is not one of those times. If Congress fails to draw hard lines that deliver on real systemic reforms, regulators cannot be counted upon to do what is needed. We need brick and mortar, not human judgment, to cleave the banks from investment banking again. We need stone walls – not regulatory oversight – to prevent institutional conflicts of interests that inevitably bring financial disaster to millions of Americans.

We must create a system, as the saying goes, of laws and not of men. While Congress is by nature a compromiser, we must do better than our usual legislative ambiguity. We must provide these agencies – the Fed, the SEC, the FDIC, the OCC, the CFTC, and others – with the statutory clarity and the bright lines they need to enforce the law.

That is why Congress needs a bold and clear plan that ends taxpayer bailouts for Wall Street and eliminates the problem of too big to fail. In my view, the core part of that plan must include three critical features. First, we must reimpose the kind of protections we had under Glass-Steagall, completely separating traditional commercial banking activities from the activities of investment banks.

Second, we must impose and leverage constraints on the non-bank players to ensure that they never again become too big to fail. And, third, we must address the fundamental conflicts of interest in modern investment banking that permit proprietary trading to come before serving customers.

I was proud to join Senators Cantwell and McCain in sponsoring a bill that would reimpose Glass-Steagall. By statutorily splitting apart massive financial institutions that house both banking and securities operations, we will go a long way towards fixing too big to fail.

As important as reimposing the protections of Glass-Steagall, we must also understand that the financial world has changed enormously since it was last in place. Investment banking is no longer an advisory business where small partnerships jealously guard their capital. Instead it is dominated by highly-leveraged behemoths that trade for their own account.

So, while Glass-Steagall firewalls would protect federally insured deposits and eliminate the conflicts in combining commercial and investment banking, it wouldn't eliminate the possibility of a large, leveraged, and interconnected firm like Lehman Brothers from creating havoc in the financial system.

For that reason, Congress must take other prudential steps.

We can begin with the other concept put forward by the Obama-Volcker proposal – placing limits on debt. Wall Street banks were able to fly too high on borrowed wings by leveraging their threadbare capital base well over thirty times, allowing a firm like Lehman Brothers to finance a trillion dollar balance sheet of illiquid trading assets through short term debt.

I repeat, we can't depend upon regulators and their discretionary judgments to ensure that this does not happen again. Instead, we need a strict limit on the of investment banks' liabilities. There is already such a limit in place for bank deposits – no individual bank can hold more than 10% of the of total national deposits.
That deposit limit can be applied to nonbank liabilities such that no investment bank can have liabilities equal to more than 10% of total deposits. With this limit, we can ensure that never again will the so-called shadow banking system eclipse the real banking system.

Two other problems in the current crisis were the questionable quality of bank capital and the arbitrary nature of regulators' risk-based capital assessments. Lehman Brothers, in fact, had more than double its required capital only days before it failed – in part due to a loosening of the definition of capital and in part due to unrealistic valuations of how risky Lehman's assets actually were. We can eliminate these problems with a simple statutory leverage requirement that is based upon banks' core capital, that is to say, their common stock plus retained earnings. Such a requirement would supplement regulators' more highly-calibrated risk-based assessments.

In short, it would provide a sorely-needed gut check that ensures that regulators don't miss the forest for the trees when assessing the capital adequacy of a financial institution. Finally, as many of my colleagues know, I have focused a lot on the problems associated with conflicts of interests, including those at banking institutions.

One of the key problems is that proprietary trading poses an inherent conflict of interest — instead of seeking the best prices for their clients' order, brokers can trade against or even in front of them — a potential profit-motive that could disadvantage their customers.

Given that, we need to think critically about how we can address the conflicts inherent in the modern investment banking model that places the traditional businesses of merger advice and securities underwriting under the same roof with proprietary trading, hedge funds and private equity investments. For example, under this business model, it's become commonplace for a firm to underwrite securities and then short them within a week. This and other problematic practices need to be restricted.

Chairman Volcker is absolutely right that proprietary businesses are not appropriate for commercial banks. More to the point, it's becoming clear we need stronger protections against conflicts of interest at investment banks, who play a critical role both in providing clients with advice on mergers, equity offerings, and debt offerings as well as in providing liquidity and making markets in securities.

Of course, there are some who will claim that all of these remedies are too prescriptive – that they constitute overregulation. It is too late to "unscramble the eggs," they say, so let's just move on. Or let's just "leave it to the regulators" to develop appropriate rules and remain flexible.

That is the road to another financial disaster. If Congress fails to impose needed structural and institutional change, the same systemic risks to our financial system will remain; indeed, they will get worse with each financial crisis because the federal safety net gets bigger.

And when the next crisis occurs, the legislative pendulum will suddenly shift direction and it will fall hard on Wall Street. Very hard, if we and Wall Street do not act together in a realistic and constructive spirit first.

I'm always astounded that I continue to hear these hoary arguments about overregulation when, in fact, we have had precious little regulation at all, particularly since Glass-Steagall was eliminated a decade ago.

Risk taking is a fundamental part of finance. Without risks, markets don't work. But the balancing act between safety on one side, and growth and innovation on the other, cannot tilt too far in the wrong direction. If we don't act, as sure as I'm standing here, the short-term trading profits on Wall

Street today threaten to become the losses born by the rest of America down the road.

As Chairman Volcker said at the banking committee hearing this week, if we do not heed his warning, the next disaster may not take place in his lifetime, but it will come, and his soul will come back to haunt us.

The American people already know this basic truth, even if Wall Street does not.

They may not understand the complexities of the banking system, and, indeed, only a handful of math PhD's can follow the complex algorithms that help create much of today's exorbitant trading profits. But people do know that banks are not designed to be trading machines. They know that banks should make their money taking deposits and lending money, which in turn provides capital for growth, creates jobs, and provides opportunities for more jobs and more growth.

You can call it populism. But you can also call it good old common sense, born once again in the lessons of hard economic times brought about by Wall Street excesses. That common sense needs to be returned to our nation’s financial system.

We must shrink bankers' outsized sense of entitlement and return to a more realistic vision of their role in society. Bankers are not traders. Nor should they be. Banks should be too safe to fail, not so large that we cannot permit their failure.

We should structurally reform the conflicts of interest that threaten to erupt again in crisis and financial loss. We must build again the edifices that will keep the American economy safe from financial crisis for decades to come.